

The Taxation Section Presents

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Life Insurance Boot Camp

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Life Insurance

Internal Revenue Code Sections 7702 and 7702A: An Introduction to the Tax Rules Affecting Life Insurance Products

Washington, DC
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Disclaimers

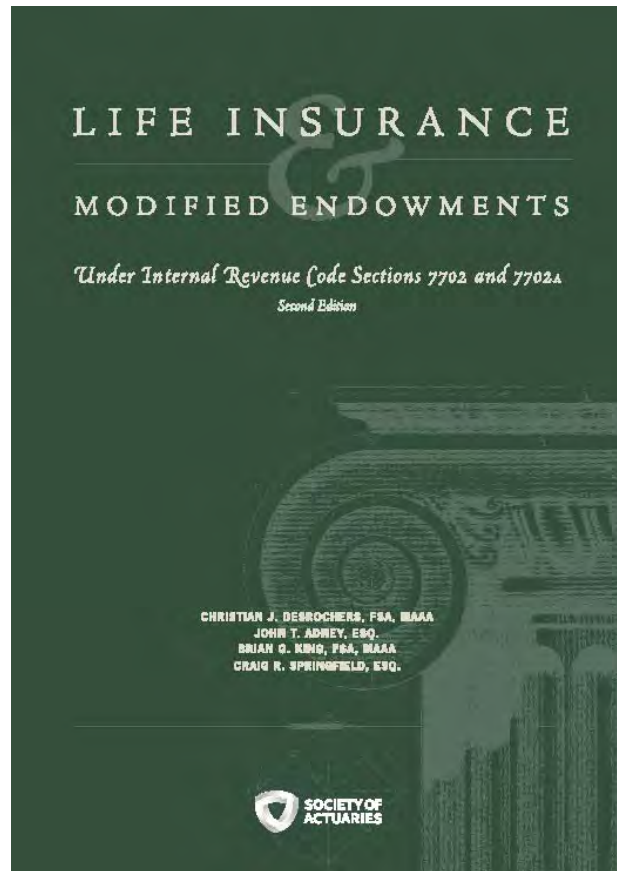
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Life Insurance & Modified Endowments Under Internal Revenue Code Sections 7702 and 7702A, Second Edition



- The content of this presentation was developed from the Society of Actuaries textbook, *Life Insurance & Modified Endowments Under Internal Revenue Code Sections 7702 and 7702A, Second Edition*.

Overview

- Part 1: Introduction
 - Tax Rules Applicable to Life Insurance
 - An Introduction to Sections 7702 and 7702A
- Part 2: Computing the Internal Revenue Code (IRC) Section 7702 and 7702A Limitations
 - Methods and Assumptions
 - Future Benefits, Death Benefits and Qualified Additional Benefits (QABs)
 - Adjustments, Material Changes and Exchanges

Part 1: Introduction

Tax Rules Applicable to Life Insurance

Income Tax Treatment of Life Insurance Contracts

- Taxation of death benefits
 - Death benefit exclusion, IRC Section 101(a)(1)
 - Transfer for value rule, IRC Section 101(a)(2)
 - Payout of death benefits over time, IRC Section 101(d)
 - Employer-owned life insurance, IRC Section 101(j)
- Taxation of the inside buildup and lifetime distributions
 - Tax deferral on the “inside buildup”
 - Taxation of lifetime distributions
 - Last in, first out (LIFO) treatment for modified endowment contracts (MECs)
 - First in, first out (FIFO) treatment for non-MECs
 - Recapture rules

Income Tax Treatment of Life Insurance Contracts (cont.)

- Other tax rules applicable to life insurance contracts
 - Premium and interest deduction limits, IRC Sections 163, 263 and 264(a) and (f)
 - Contract exchanges, IRC Section 1035
 - Contract sales and gifts, IRC Section 1001 et seq.
 - Deduction of loss on surrender or sale? IRC Section 165
 - Variable contracts
 - IRC Section 817(h) diversification requirements
 - Investor control

Life Insurance Defined

- Common law rules
 - Insurable interest
 - Risk shifting and risk distribution
- Statutory limitations (“Rule Eras”)
 - Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA): IRC Section 101(f)
 - Flexible premium contracts issued before January 1, 1985
 - Temporarily addressed universal life tax issues
 - Deficit Reduction Act of 1984 (DEFRA): IRC Section 7702
 - Applies to all life insurance contracts issued January 1, 1985, and later
 - Actuarial tests for qualification
 - Technical and Miscellaneous Revenue Act of 1988 (TAMRA): IRC Section 7702A
 - MEC (7-pay) testing required for contracts entered into on or after June 21, 1988
 - “Reasonable” mortality and expenses in calculations for contracts entered into on or after October 21, 1988

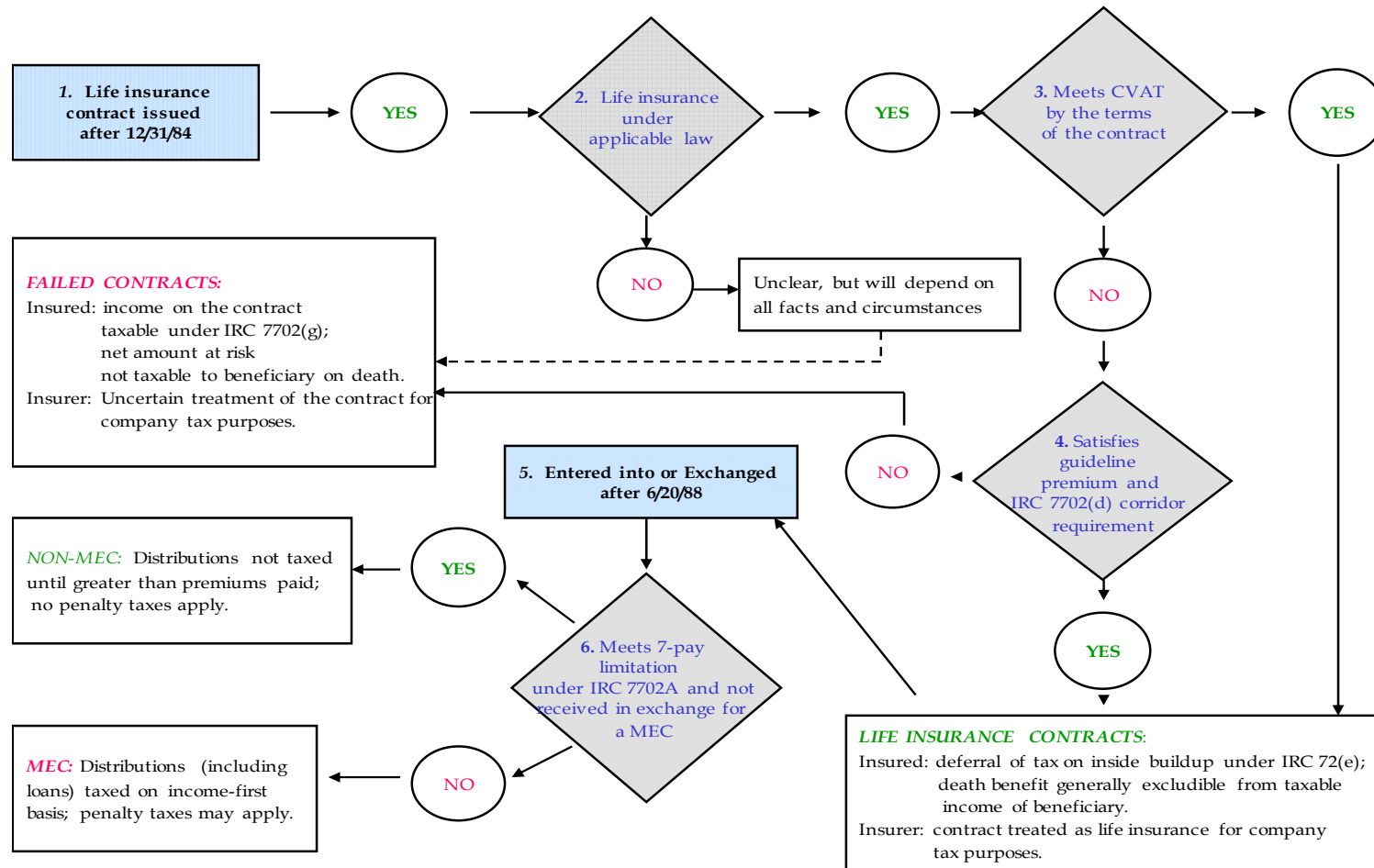
The Role of IRC Sections 7702 and 7702A in Life Insurance Taxation

- IRC Section 7702 defines a “life insurance contract”
 - Must be a life insurance contract under “applicable law”
 - A single integrated contract under state or foreign law
 - Foreign contract considerations
 - Canadian requirements
 - Foreign Account Tax Compliance Act
 - Must satisfy one of two actuarial tests (the cash value accumulation test (CVAT) or the guideline premium test (GPT)), which regulate the relationship of the premium, cash value and death benefits
- IRC Section 7702A defines a “modified endowment contract” or MEC
 - A MEC is a life insurance contract that fails to satisfy the 7-pay test, or which is received in exchange for an existing MEC
 - MEC status affects the taxation of lifetime distributions
 - Annuity tax treatment applies to a MEC – i.e., LIFO tax treatment for distributions, including loans, and a penalty tax may apply

Classes of Life Insurance

- Classes of life insurance
 - IRC Section 7702 compliant contract that is a non-MEC
 - Investment-first distributions during the insured's life (FIFO)
 - IRC Section 7702 compliant contract that is a MEC
 - Annuity distribution rules (LIFO or income distribution first)
 - Failed life insurance contract
 - Earnings currently taxable under IRC Section 7702(g)
- Importance of determining the proper “classification”
 - Sets forth the tax reporting and withholding requirements for distributions to policy owners and beneficiaries
 - Failing to properly classify contracts exposes insurers to potential withholding and reporting penalties, policy owner complaints, etc.

Qualification Under IRC Section 7702 and 7702A



Note on Tax Authorities

- US Constitution
- Statutes (IRC)
- Regulations
- Revenue rulings and procedures
- IRS notices
- Private letter rulings (PLRs) and other non-precedential IRS guidance
- Judicial decisions

Part 1: Introduction

An Introduction to Sections 7702 and 7702A

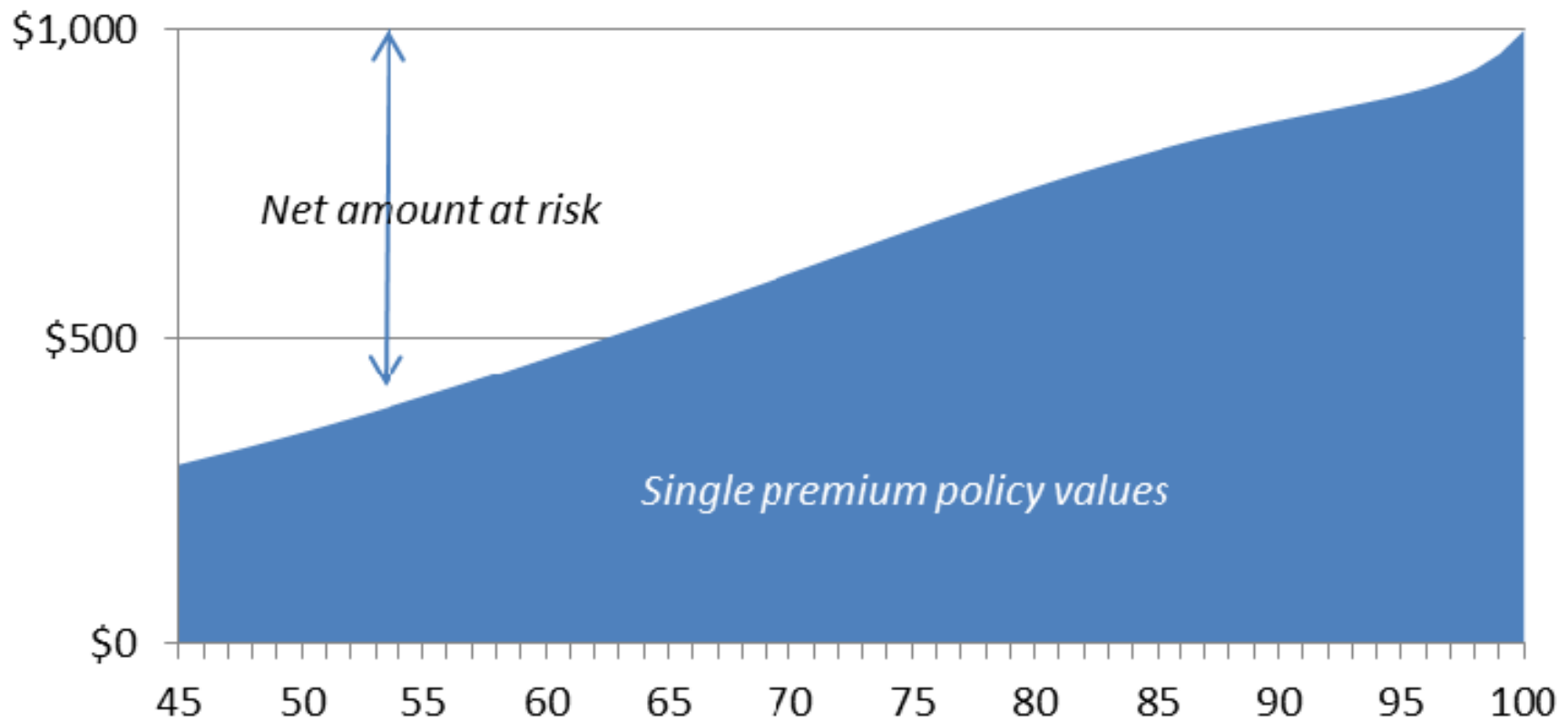
The Model or Test Plan Concept

- The limitations imposed by IRC Section 7702 are based on the actuarial present value of “future benefits,” expense and rider charges.
 - Actuarial safeguards were built in to preclude “manipulation” of plan designs that could result in an overstatement of the actuarial limitations.
 - Constrains investment orientation, not contract terms
 - These safeguards place restrictions on the contractual benefits and statutory assumptions used to compute the actuarial limitations.
 - Permissible future benefits and rider charges taken into account
 - Statutory interest, mortality and expense assumptions

Cash Value Accumulation Test

- First alternative definitional test
- By the terms of the contract, the cash surrender value (CSV) cannot exceed the net single premium (NSP) required to fund future benefits under the contract at any point in time.
- Satisfying the “terms of the contract” requirement
 - The CVAT is a prospective test that must be met at all times.
 - A contract that will not meet the CVAT at some future date will be considered to have failed the test at issue.
 - It must therefore be impossible for the CSV to exceed the NSP under the contract’s mechanics.

**Figure 2.1. CVAT limitations: net single premium;
\$1,000 death benefit**



Assumptions: 2001 CSO male aggregate, ANB, 4%, age 45

The CVAT Net Single Premium

- The NSP defines the maximum allowable CSV for a given death benefit for a qualifying CVAT contract, and is computed based on the following assumptions:
 - Interest
 - Annual effective interest of 4% or, if greater, the rate or rates guaranteed on issuance of the contract
 - Mortality:
 - For contracts entered into before October 21, 1988, the mortality charges specified in the contract
 - For contracts entered into on or after October 21, 1988, “reasonable” mortality charges
 - Expenses
 - No expenses, except certain expenses for QABs, may be taken into account.
 - IRC Section 7702(e) restricts the benefits that may be taken into account in the computation (more to come)

Cash Surrender Value

- The CSV for purposes of measuring CVAT compliance is defined in Section 7702(f)(2)(A) as follows:

the cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends.

- IRS and other related guidance for defining a contract's CSV
 - Legislative history
 - Proposed regulation Section 1.7702-2
 - Notice 93-37
 - IRS letter rulings
 - Return of premium benefits and other non-insurance benefits payable or with value
 - More to come ... or maybe not?

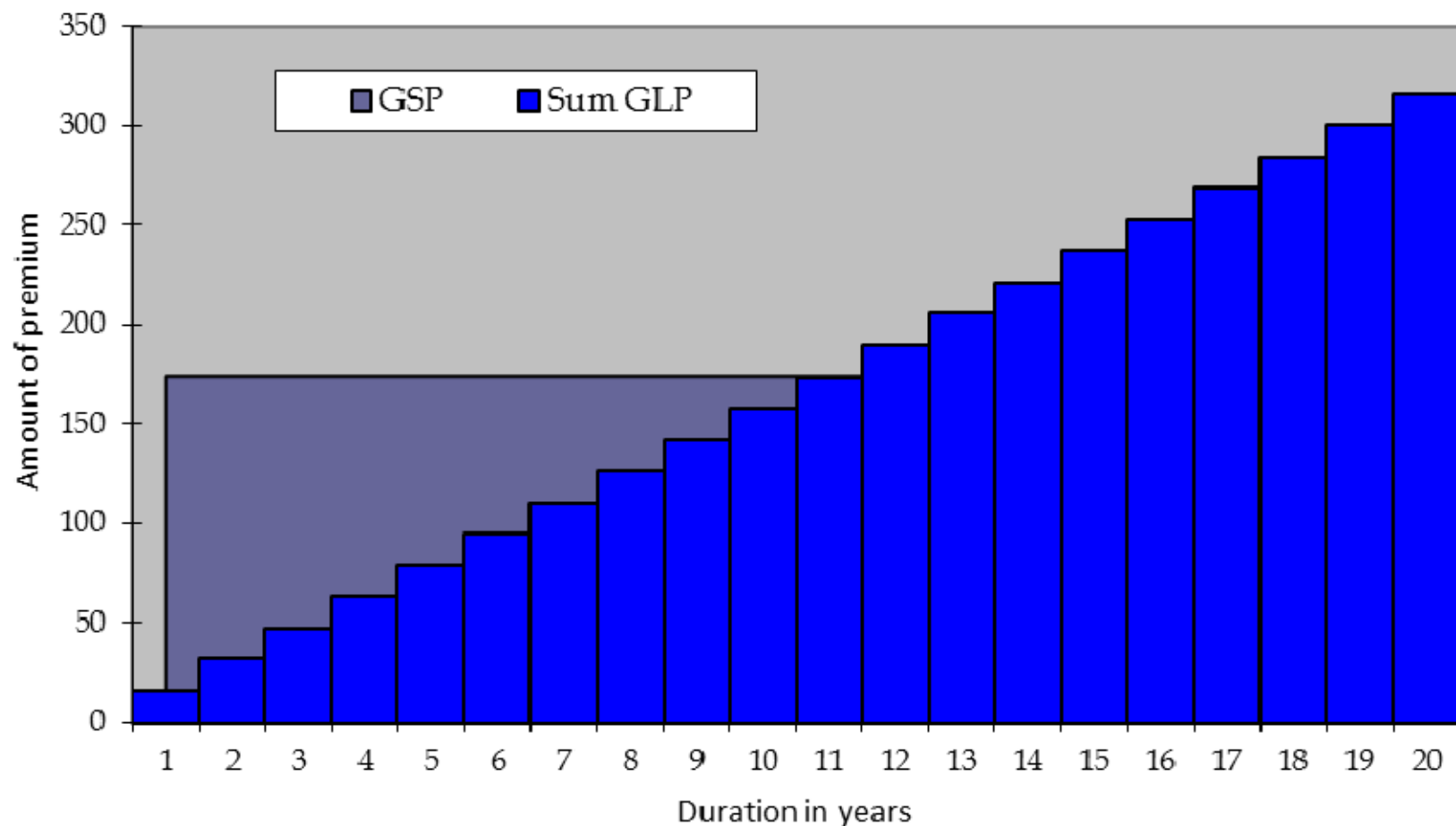
Guideline Premium and Cash Value Corridor Test

- The second alternative definitional test
- A dual-element test that restricts the allowable premiums and CSV for a given death benefit
 - Part 1 – The guideline premium test
 - Gross premiums paid under the contract cannot exceed the guideline premium limitation
 - The guideline premium limitation as of any date is the greater of:
 - The guideline single premium (GSP)
 - Sum of the guideline level premiums (GLPs) to date
 - Part 2 – The cash value corridor test
 - Death benefits are required to be at least a specified percentage of the CSV
 - Specified percentages are defined in IRC Section 7702(d)

Guideline Premiums

- Guideline premiums are computed based on the following:
 - Interest:
 - Annual effective interest of 6% (GSP)/4% (GLP), or, if greater, the rate or rates guaranteed on issuance of the contract
 - Mortality:
 - For contracts entered into before October 21, 1988, the mortality charges specified in the contract
 - For contracts entered into on or after October 21, 1988, “reasonable” mortality charges
 - Expenses (including charges for QABs):
 - For contracts entered into before October 21, 1988, the charges specified in the contract
 - For contracts entered into on or after October 21, 1988, “reasonable” charges (if specified) that are “reasonably expected to be actually paid”
 - IRC Section 7702(e) restricts the benefits that may be taken into account in the computation (more to come)

Figure 2.2. Guideline premium limitation per \$1,000 of death benefit



Assumptions: 2001 CSO male aggregate, 4% GLP, 6% GSP, age 45, endowment at 100

Premiums Paid

- IRC Section 7702(f)(1) defines premium paid to be the premiums paid under the contract less:
 - Distributions that are not taxed under IRC Section 72(e)
 - Excess premiums described by IRC Section 7702(f)(7)(B)
 - Force-out amounts returned (with interest) within 60 days of the end of a contract year
 - Other amounts specified in regulations
- Premiums paid may differ from the IRC Section 72(e) “investment in the contract”
 - Examples – IRC Section 1035 exchanges; situations where 60-day or recapture rules apply

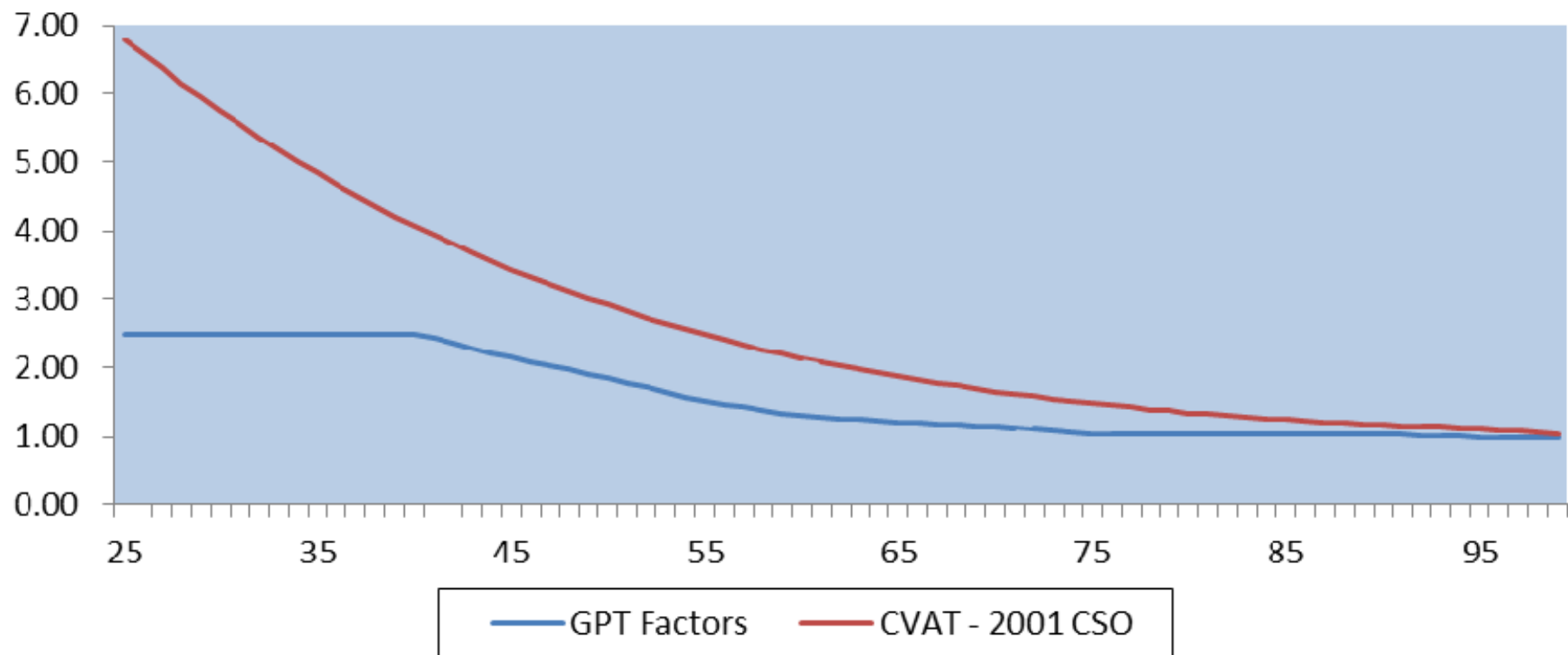
Premiums Returned

- If a premium must be returned to comply with the guideline limitation, any “force-out” amount returned within 60 days after the end of a contract year will reduce the premiums paid during that year
 - The statute refers to the return of “any premium paid during any contract year”
 - The premium that is returned need not be an amount paid during the year in which it is returned
 - Interest must accompany the amount being returned and is taxable (but it does not reduce premiums paid)

IRC Section 7702(d) Corridor Requirements

- Like the CVAT, the GPT has a minimum death benefit, or “corridor” requirement
 - “Corridor factors” are prescribed in IRC Section 7702(d) to assure the existence of a minimum net amount at risk
- Relative to the CVAT, the minimum required death benefit under the GPT is generally less
 - A “corridor death benefit” generally occurs later on a GPT plan than a CVAT plan

Figure 2.3. Minimum death benefit per \$1 of CSV



CVAT assumptions: 2001 CSO male aggregate, ANB, 4% interest, endowment at 100

Choice of Tests Under IRC Section 7702

- Universal life and other types of flexible premium products
 - Can be designed to comply with either the GPT or CVAT, with GPT more common
 - GPT vs. CVAT considerations
 - Initial funding v. later duration net amount at risk (NAAR) requirements
 - Necessary premium test (NPT) functionality required for CVAT
 - Will low interest rates and continued improvements in mortality (e.g., 2017 CSO) increase the prevalence of CVAT designs?
- Traditional whole life and other types of fixed premium products, including interest-sensitive whole life or fixed-premium universal life
 - Almost exclusively CVAT

Modified Endowment Contracts Under IRC Section 7702A

- Defined in IRC Section 7702A(a)
- A MEC is:
 - A life insurance contract within the meaning of IRC Section 7702
 - “Entered into” on or after June 21, 1988
 - A contract that fails to meet the 7-pay test prescribed in IRC Section 7702A(b)
 - Or is received in exchange for a MEC

MEC Distributions

- Lifetime distributions (e.g., policy loans, partial withdrawals and policyholder dividends) from a MEC are subject to more restrictive tax rules:
 - Annuity rules in IRC Section 72(e) apply – LIFO treatment of distributions, including loans and assignments
 - IRC Section 72(e)(4)(B) treatment for dividends retained
 - 10% penalty tax, subject to certain exceptions for individuals

The 7-Pay Test

- A premium-based test that limits the allowable premium for a 7-year period
 - First year after issue:
 - A contract will fail the 7-pay test if the accumulated amount paid under the contract, at any time during that contract year, exceeds the “7-pay premium”
 - Second through seventh contract years:
 - Accumulated amounts paid under the contract are compared to the sum of the 7-pay premiums accrued to date

The 7-Pay Premium

- The 7-pay premium is a “net” level annual premium needed to pay up the contract in seven years
- Computation of the 7-pay premium generally follows the CVAT rules applicable to the NSP
 - Interest
 - Annual effective interest of 4% or, if greater, the rate or rates guaranteed on issuance of the contract
 - Mortality:
 - For contracts entered into before October 21, 1988, the mortality charges specified in the contract
 - For contracts entered into on or after October 21, 1988, “reasonable” mortality charges
 - Expenses
 - No expenses, except certain expenses for QABs, may be taken into account
 - IRC Section 7702A(c)(1) and 7702(e) restrict the benefits that may be taken into account in the computation (more to come)

MEC Miscellany

- 7-pay premium is increased by \$75 if:
 - Initial death benefit of \$10,000 or less and the contract requires payment of at least seven non-decreasing premiums
 - Application is generally limited to fixed premium whole life contracts
- Modal premium
 - Regulatory authority never exercised
- Aggregation rule
 - All MECs issued by the same insurance company to the same policyholder in the same calendar year are to be treated as one contract (an anti-abuse rule) under IRC Section 72(e)

*Part 2: Computing the IRC Section 7702 and
7702A Limitations*

Methods and Assumptions

Calculation Methods

- Methods by which actuarial values are to be computed are not specified
- Two principal methods that are commonly applied to the calculation of values:
 - Retrospective calculation or basic actuarial principles (including the use of commutation functions)
 - Prospective calculation or projection-based (or illustration system) approach
- Processing Frequency
 - The time interval over which policy-level events are assumed to occur
 - Curtate vs. continuous death benefit payments
 - Monthly vs. annual computational assumptions
 - Does not affect the interval over which premiums are assumed payable for purposes of computing the GLP and the 7-pay premium
 - Guideline level and 7-pay premiums are defined by IRC Sections 7702 and 7702A as level annual amounts

Actuarial Assumptions

- Restrictions on actuarial assumptions (mortality, interest and expenses) are key elements in developing the definitional limitations
- Contract provisions and guarantees form the basis of the actuarial assumptions
 - Statutory restrictions are imposed, with differences depending upon the issue date of the contract (“Assumption Eras”)
 - Intended to restrict the ability of product designers to increase the definitional limits artificially through manipulation of the assumptions

Interest

- Interest rates are the greater of the statutory rates or the rate or rates guaranteed upon issuance of a contract
- Statutory rates
 - GSP: 6%
 - GLP: 4%
 - CVAT NSP: 4%
 - Seven-pay premium: 4%

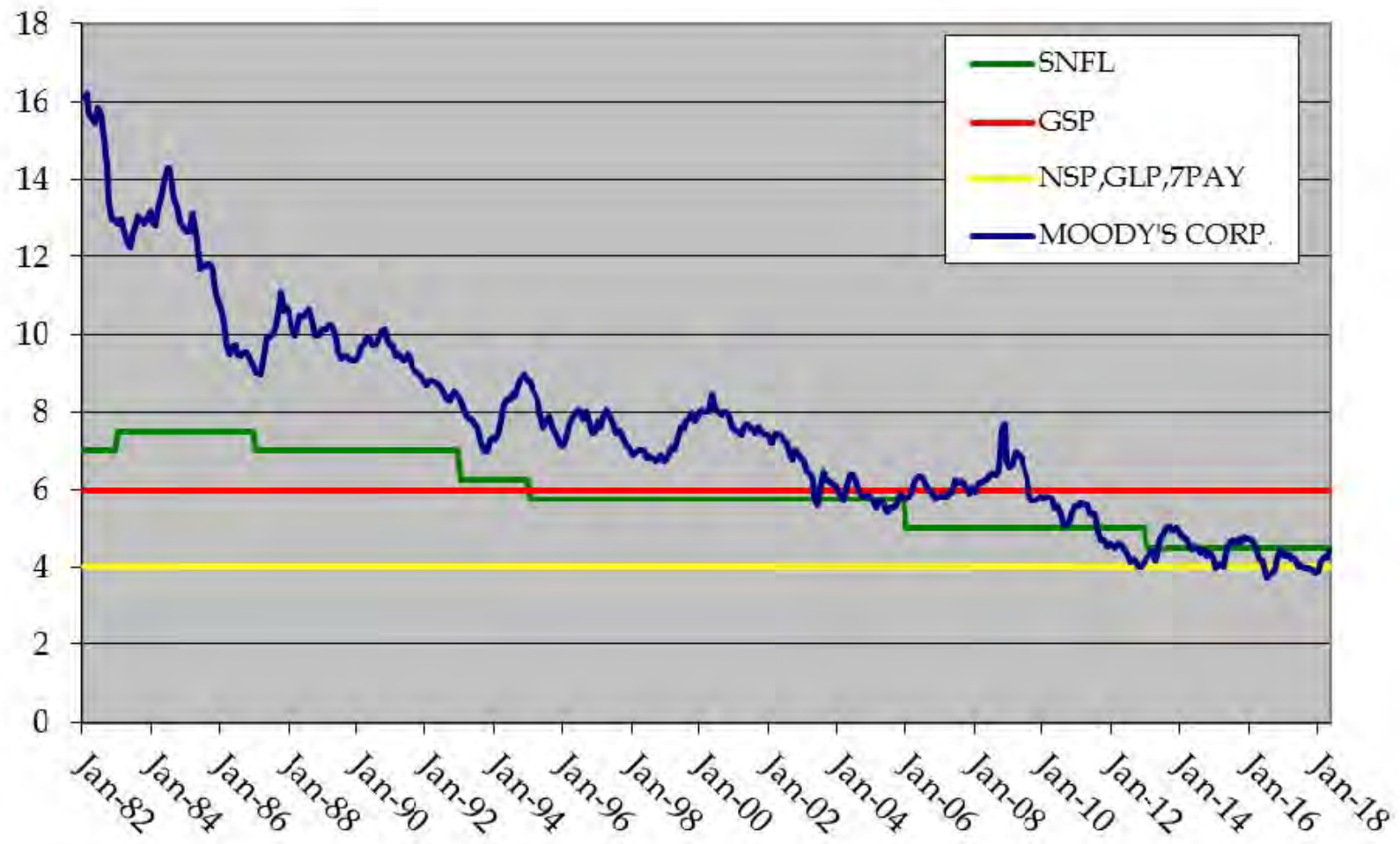
Interest (cont.)

- Treatment of initial guarantees
 - The interest guarantee and the duration for which it applies (and however arising) must be reflected in calculations
 - Short-term guarantees (extending no more than one year) are de minimis in guideline level premium, but not in guideline single premium, the net single premium or the 7-pay premium
 - Bonus interest and similar amounts
- Treatment of post-issue guarantees
 - Interest crediting guarantees lasting up to 12 months that arise after a policy's issue usually are not "interest rate guarantees" (PLR 199929028)
 - "One can reasonably infer that the drafters of section 101(f) may have viewed excess interest credits that vary from year to year as economically equivalent to policyholder dividends" (PLR 9723040)
 - "One also might reasonably infer that the annual declaration of an excess interest rate should not have any effect on a contract's guideline premium limitation"

CVAT Interest Rates

- For CVAT contracts, the statutory minimum interest rate may serve to impose an indirect limitation on traditional whole life product designs
 - The Standard Nonforfeiture Law (SNFL) defines minimum required cash surrender value based on maximum prescribed interest rates – the “floor” cash value
 - The SNFL maximum interest rate is based on the statutory valuation rate, which is tied to the Moody’s Corporate Average
 - The recent adoption of the Valuation Manual includes a provision in VM-02: Minimum Nonforfeiture Mortality and Interest that floors the nonforfeiture interest rate at 4%
 - IRC Section 7702 defines maximum permissible cash surrender values based on the interest rate (or rates) guaranteed in the contract – the “ceiling” cash value
- A CVAT contract assuming an interest rate lower than 4% could not meet the “terms of the contract” requirement at the time the contract becomes paid-up and would thus fail the CVAT at issue

Selected Interest Rates 1982-2018



Mortality: Pre-TAMRA

- IRC Section 101(f)
 - “Mortality and other charges guaranteed under the contract”
- IRC Section 7702
 - “Entered into” before October 21, 1988
 - “Mortality charges specified in the contract (or, if none is specified, the mortality charges used in determining the statutory reserves for such contract)”
- “Specified in the contract” generally interpreted as guaranteed mortality rates

Reasonable Mortality Standard

- TAMRA imposed restrictions on mortality charges used in computing definitional limits under IRC Sections 7702 and 7702A for contracts issued on or after October 21, 1988
- The Permanent Mortality Rule of IRC Section 7702(c)(3)(B)(i)
reasonable mortality charges which meet the requirements prescribed in regulations to be promulgated by the Secretary or that do not exceed the mortality charges specified in the prevailing commissioners' standard tables as defined in subsection (f)(10) [of section 7702]
- The Interim Mortality Rule of Section 5011(c)(2) of TAMRA
Reasonable mortality charges that do not differ materially from the charges actually expected to be imposed by the company, taking into account any relevant characteristics of the insured of which the company is aware
 - Applies to contracts issued on or after October 21, 1988, but before the effective date of final regulations
 - Final regulations have yet to be issued on reasonable mortality
 - The interim rule is currently an operative rule, including for substandard risks

IRS Reasonable Mortality Guidance

- Notice 88-128
- 1991 Proposed Regulation
- Notice 2004-61
 - Issued in response to the adoption of the 2001 CSO tables
 - Replaced by Notice 2006-95
- Notice 2006-95
 - Supplements Notice 88-128
 - Superseded and replaced Notice 2004-61
 - Replaced by Notice 2016-63
- Notice 2016-63
 - Issued in response to the adoption of the 2017 CSO tables
 - Supplements Notice 88-128
 - Modifies and supersedes Notice 2006-95

IRS Mortality Notices

- The IRS mortality notices provide safe harbors for 1980, 2001 and 2017 CSO contracts
 - Safe harbor effective dates generally align with the NAIC permitted and required dates for valuation and nonforfeiture purposes
 - Safe harbor conditions vary with regard to the treatment of policy guarantees
- The notices also provide effective date rules for determining a contract's issue date for purposes of the safe harbors
 - Differing potential impacts of changes “pursuant to contract terms” versus those that are not

Substandard Mortality

- Pre-TAMRA
 - Before the imposition of the reasonable mortality rules, mortality charges were based on the contractually guaranteed rates (i.e., the mortality rates specified in the contract)
- Post-TAMRA
 - TAMRA interim rule requires charges reflected to not “differ materially” from those expected to be imposed taking “into account any relevant characteristic of the insured of which the company is aware”
 - May imply that a company must have some underwriting or other basis for expecting that its actual mortality charges will exceed standard mortality charges
 - IRS notices exclude any discussion relating to substandard contracts
 - Variations exist in how companies reflect substandard mortality
 - Multiplicative approach: Substandard table or percentage rating applied to the reasonable mortality applicable to a standard contract
 - Additive approach: The amount necessary to maintain the same margin between guaranteed and current mortality charges as that applicable for a standard risk contract
 - Current charge approach: Mortality charges that exceed reasonable mortality charges, but only to the extent of expected actual charges

Final Regulation on Age

- Regulation Section 1.7702-2
 - Applies to contracts issued after December 31, 2008 or issued on or after October 1, 2007 that are based upon the 2001 CSO
- Can determine age by birthday (“actual age”) or by reference to contract anniversaries, staying within 12 months of actual age
 - Allows for both age-nearest and age-last birthday
 - However done, must be applied consistently throughout IRC Section 7702
 - Applies only for certain purposes under the statute – GLP calculation, cash value corridor and computational rules
- Multi-life contracts
 - For last-to-die contracts, the only relevant age is that of the youngest insured
 - For first-to-die contracts, the only relevant age is that of the oldest insured
 - Regulations prohibit use of a “blended” or derived age (such as joint equal age) for maturity date or IRC Section 7702(d) cash value corridor
- Relationship to IRC Section 7702A material change rule?

Expense Charges

- Parallels exist in the legislative history regarding the treatment of expense charges (including charges for QABs) and mortality charges in both IRC Section 101(f) and IRC Section 7702
- Pre-TAMRA
 - Like mortality, companies were permitted to use “the maximum [expense] charges guaranteed at issue for the life of the contract”
- Post TAMRA, IRC Section 7702(c)(3)(B)(ii) requires the use of:

any reasonable charges (other than mortality charges) which (on the basis of the company’s experience, if any, with respect to similar contracts) are reasonably expected to be actually paid.

- Regulations have yet to address reasonable expenses, leaving open various interpretations of the terms “reasonable” and “reasonably expected to be actually paid”
- Insurers tend to use their current charges

*Part 2: Computing the IRC Section 7702 and
7702A Limitations*

*Future Benefits, Death Benefits and Qualified
Additional Benefits*

Computational Rules

- Similar to limitation on the actuarial assumptions, computational rules restrict the future benefits that can be assumed in the calculation of the definitional limits under Sections 7702 and 7702A
- IRC Section 7702(e)(1)(A): The death benefit used in computing the guideline premiums or NSP is generally assumed not to increase
 - Section 7702(e)(2)(A) GLP “Relief”: For the GLP, an increasing death benefit may be taken into account to the extent necessary to prevent a decrease in the excess of the death benefit over the cash surrender value (i.e., non-increasing risk)
 - Section 7702(e)(2)(B) CVAT “Relief”: The increase described in IRC Section 7702(e)(2)(A) may be taken into account “assuming that the net level reserve (determined as if level annual premiums were paid for the contract over a period not ending before the insured attains age 95) is substituted for the net single premium
- IRC Section 7702(e)(1)(B): The maturity date assumed in the calculations must be between attained ages 95 and 100.
- IRC Section 7702(e)(1)(C): Death benefits are assumed to be provided until the “deemed” maturity date
- IRC Section 7702(e)(1)(D): The amount of any endowment benefit (or sum of endowment benefits) taken into account cannot exceed the least amount payable as a death benefit at any time

Maturity Date Beyond Age 100

- The 2001 CSO tables for the first time provided for mortality rates that extend beyond age 100, which raised questions around how IRC Section 7702 and 7702A limits should be calculated for contracts that mature after age 100
- Notice 2009-47
 - Proposed “Age 100 Safe Harbor Testing Methodology” for satisfying the IRC Section 7702 and 7702A requirements
 - Safe harbor adopted recommendation proposed by the 2001 CSO Maturity Age Task Force of the SOA Taxation Section published in *TAXING TIMES* (May 2006)
- Revenue Procedure 2010-28
 - Adopted similar “Age 100 Safe Testing Methodology” from Notice 2009-47
 - Limited applicability to 2001 CSO contracts
- Revenue Procedure 2018-20
 - Modifies and supersedes Revenue Procedure 2010-28
 - Extends applicability of Revenue Procedure 2010-28 to 2017 CSO contracts and contracts with mortality guarantees based on future prevailing commissioners’ standard mortality tables that extend beyond age 100

Maturity Date Beyond Age 100 (cont.)

- Age 100 Safe Harbor Testing Methodology
 - All IRC Section 7702 and 7702A calculations assume contract matures at age 100
 - CVAT and NPT: NSP assumes endowment at age 100
 - GLP: Assume premium payments through age 99
 - Sum of GLP: Increase through a date no earlier than 95 and no later than 99
 - Testing continues thereafter, but the sum of the GLPs remains constant
 - Material changes between ages 93 and 100
 - 7-pay premium is calculated based on number of years remaining to age 100
 - 7-pay premium limitation would increase to age 100
 - Sum of 7-pay premium limitation remains constant after age 100 for remainder of 7-pay test
 - Reductions in benefits
 - Rules continue to apply for the full seven years (forever in the case of joint and survivor contracts)
 - Post-age 100 adjustments and material changes
 - Not treated as a material change or an adjustment event

Section 101(f) Computational Rules

- The IRC Section 101(f) computational rules largely parallel the IRC Section 7702 computational rules, with the following notable exceptions:
 - The GSP can incorporate option 2 death benefits
 - QABs are not permitted in the calculation of the CVAT NSP
 - The GSP and GLP can use a maturity date that is 20 years after the date of issue or (if earlier) age 95
 - The GLP must assume premiums for 20 years, or (if earlier) to age 95
- Note that IRC Section 101(f) applies to all flexible premium contracts issued before January 1, 1985

7-Pay Computational Rules

- IRC Section 7702A also incorporates the IRC Section 7702(e)(1) computational rules with certain exceptions regarding decreases in benefits
- Reduction in benefits after the first 7 contract years
 - IRC Section 7702A(c)(1)(B) requires the death benefit provided for in the first contract year be assumed to be provided until the maturity date of the contract without regard to any scheduled reduction after the first seven contract years
 - In contrast, Section 7702(e)(1)(C) deems death benefits at the inception of a contract to continue until the contract's maturity date, but this may be limited to certain fact patterns, such as for contracts that provide partial endowment prior to age 95
- Reduction in benefits in the first 7 contract years
 - IRC Section 7702A(c)(2)(A) provides that if "benefits" under the contract are reduced during the first seven contract years, then IRC Section 7702A is applied as if the contract had originally been issued at the reduced benefit level
 - The calculation rules anticipate scheduled (and unscheduled) benefit reductions in the first seven contract years
 - This rule also applies in the first seven years following a material change

Qualified Additional Benefits

- Like the term “modified endowment,” the term “qualified additional benefit” has no meaning outside of IRC Sections 101(f), 7702 and 7702A
- While the statute lists the QABs, their status as “additional benefits” casts light on the meaning and treatment of additional benefits that are not “qualified”

Qualified Additional Benefits (cont.)

- The list:
 - Guaranteed insurability
 - Accidental death or disability benefits
 - Family term coverage
 - Disability waiver benefit
 - Other benefits prescribed under regulations (none exist)
- Examples of non-QABs:
 - Long-term care and certain other accelerated death benefits
 - Term on non-family members (e.g., business partners)
- Status of disability income riders?
- Differing treatment of QABs under IRC Sections 101(f) and 7702

Qualified Additional Benefits (cont.)

- QABs are subject to the expense charge rule of IRC Section 7702(c)(3)(B)(ii); therefore, the rules vary with issue dates
 - The charges for the QAB, and not the benefits, are reflected in the calculations
- Reflecting QABs in the GLP
 - Charges may be amortized over the term of the QAB or over that of the contract
- Special considerations for “term on the primary” insured riders
 - Section 7702A
 - Always treated as death benefit provided coverage lasts 7 years
 - Section 7702
 - Generally treated as a QAB under IRC Section 7702 except in the case where the rider continues to age 95 or later where it is treated as death benefit

Reasonable Mortality and QABs

- In PLRs, the IRS addressed whether the reasonable mortality limitations or the reasonable expense limitations applied to QABs
 - The IRS concluded QABs are subject to the “reasonable expense charge rule” of IRC Section 7702(c)(3)(B)(ii), not the “reasonable mortality charge rule” of IRC Section 7702(c)(3)(B)(i)
- In response, the IRS issued Revenue Ruling 2005-6
 - Confirms position IRS had taken in PLRs
 - Provided a mechanism for getting relief through a closing agreement for companies that failed to apply the “reasonable expense charge rule” to QABs

Treatment of Non-QABs

- The actuarial limitations for both IRC Sections 7702 and 7702A are based on the life insurance contract only
 - The existence of the non-QAB will have no effect on the guideline premiums, NSPs or 7-pay premiums of the life insurance contract
- Amounts taken from the cash value of a life insurance contract to pay for non-QAB charges should be treated as a distribution
- Distributions arising from charges assessed against cash value for a non-QAB may reduce “premiums paid” and “amount paid” (i.e., to the same extent as any other distribution)
- See PLR 9106050

*Part 2: Computing the IRC Section 7702 and
7702A Limitations*

Adjustments, Material Changes and Exchanges

Overview

- Adjustment events under IRC Section 7702
 - Adjustment methodology
- Policy changes under IRC Section 7702A
 - Material changes
 - Reduction in benefits
 - Necessary premium
- Effective dates and loss of grandfathering

Adjustments

- IRC Sections 101(f) and 7702
 - Adjustment rules allow for changes in benefits while maintaining definitional limitations
- IRC Section 7702A
 - Certain changes are defined as “material changes”
 - Starts a new 7-pay test
 - Other changes are characterized as “reductions in benefits”
 - May modify 7-pay limit in existing test...sometimes

CVAT Adjustments

- The CVAT requires that **all** benefit changes be taken into account under adjustment rules
- The CVAT limit is equal to the NSP for future benefits computed using the IRC Section 7702 restrictions on assumed future benefits and actuarial assumptions and the insured's age
 - Contract treated as newly issued
 - The CVAT has been described as “self-adjusting”

Adjustments Under the GPT

- Policy changes to the future benefits or other terms of the contract (i.e., “adjustment events”) will require changes to the guideline premiums
- Adjustment events can include:
 - Changes in death benefits made at the request of the policyholder
 - The addition or termination of a QAB
 - A change between a level (Option 1) and an increasing (Option 2) death benefit pattern
 - The removal of a substandard rating or a change in the mortality charge guarantee from smoker to non-smoker
 - Certain changes in death benefits that result from the operation of the contract (e.g., COLA rider)

Adjustments Under the GPT (cont.)

- When adjustment events occur, an attained age layering approach is used to adjust the GSP and GLP:

$$\text{GSP}(\text{new}) = \text{GSP}(\text{old}) + \text{GSP}(\text{after})^{\text{Att. Age}} - \text{GSP}(\text{before})^{\text{Att. Age}}$$

$$\text{GLP}(\text{new}) = \text{GLP}(\text{old}) + \text{GLP}(\text{after})^{\text{Att. Age}} - \text{GLP}(\text{before})^{\text{Att. Age}}$$

- $\text{GSP}(\text{after})^{\text{Att. Age}}$ and $\text{GLP}(\text{after})^{\text{Att. Age}}$ are calculated based on the attained age of the insured and contract characteristics *after* the policy change
- $\text{GSP}(\text{before})^{\text{Att. Age}}$ and $\text{GLP}(\text{before})^{\text{Att. Age}}$ are calculated based on the attained age of the insured and contract characteristics *before* the policy change

Dividends and Excess Interest

- Certain benefit changes are considered adjustment events under the CVAT but not the GPT:
 - Declarations of excess interest (as well as of reductions in “current” mortality or expense charges) in that they affect cash value
 - Benefit increases due to policyholder dividends
 - Takes a broad view (i.e., as in IRC Section 808) of the term “policyholder dividend”
- Important to distinguish guarantees from dividends

Decrease in Benefits

- For a decrease in benefits, the “after” will be less than the “before,” resulting in a reduction in guideline premiums
- Certain types of benefit reductions can produce a negative GSP and/or GLP
 - May result in a declining guideline premium limitation over time, resulting in “force-outs” to keep policy in compliance
 - May require additional policyholder correspondence to communicate reason for distribution of “force-outs”
 - Section 7702(f)(6) allows minimum premium to be paid into contract to keep in-force if the contract would lapse without additional premiums – cumbersome and difficult to administer
- A decrease in benefits can occur due to termination of a QAB, including by reason of the death of the insured under a family term rider

Issues With the Attained-Age Method

- The adjustment rules do not create full parity between a policyholder who increases benefits under an existing contract and one who purchases a new contract
- If the decrease is large enough, the guideline premium limitation can become negative, throwing the operation of the test into question
- Contracts can become underfunded and the adjustment mechanism is inadequate to deal with this problem
 - IRC Section 7702(f)(6) is an option, but it is cumbersome

Adjustments Under IRC Section 7702A

- Two adjustment rules, which are different from those under IRC Section 7702, apply to calculations under IRC Section 7702A
- Reductions in benefits that occur within the first seven years
 - A special reduction in benefits rule applies to survivorship products (i.e., second-to-die)
- Material changes

Reductions in Benefits

- If benefits under the contract are reduced during the first seven contract years, then under IRC Section 7702A(c)(2)(A), the statute is applied as if the contract had originally been issued at the reduced benefit level
- The new reduced limitation is applied to the cumulative amount paid under the contract for each of the first seven years

Reductions in Benefits (cont.)

- Retroactive application of the 7-pay test can give rise to a MEC
 - Distributions affected (note two-year rule)?
 - Year to tax report?
- Retesting rule does not apply to a lapse due to nonpayment of premiums where a reinstatement is made within 90 days of the lapse (IRC Section 7702A(c)(2)(B) – a frequent source of problems)
- Does the retesting rule apply when benefits are paid?
- What if a contract is exchanged for one with lower benefits?

Material Changes

- When changes occur to a contract other than a reduction in benefits, the material change rule of IRC Section 7702A(c)(3) may apply
 - “Material change ... in benefits [or] terms ... not reflected in any previous determination ...”
- The material change rule applies throughout the life of a contract
 - It does not cease applying after a contract passes through a 7-pay testing period without becoming a MEC

Material Changes (cont.)

- “Material changes” include changes in contract terms and any increase in the death benefit or any increase in, or addition of, a QAB
- Upon the occurrence of a material change, the contract is treated for purposes of IRC Section 7702A as a new contract entered into on the day the material change takes effect
 - The computed 7-pay premium must be adjusted to take into account the contract’s existing CSV at the time of the material change
 - It will be tested from that point forward, over the ensuing seven years, to determine whether it will meet a new 7-pay test

Material Changes (cont.)

- Exceptions to the material change rule
 - A material change does not include death benefit increases “attributable” to “necessary premiums” and interest and earnings thereon
 - Due to this NPT exception, one must distinguish between:
 - A “material change event” (i.e., policy changes that would be material changes but for application of the NPT)
 - A “material change” (i.e., the point in time when a material change is recognized under IRC Section 7702A(c)(3)(A))
 - To the extent provided in regulations, any cost-of-living adjustment (COLA) increase (with conditions) is not a material change
 - Must be based on an established broad-based index
 - Must be funded ratably over the remaining premium paying period
 - BUT, no regulations to date and none expected (i.e., provision is inoperative)

Necessary Premium Test

- The general rule for the NPT is that recognition of a benefit increase as a material change “may” be deferred if there is no unnecessary premium in the contract
 - The more common application of the NPT allows for death benefit increases occurring under the normal operation of the contract (e.g., death benefit increases due to “corridor,” growth in the cash surrender value for option 2 contracts, and dividend purchased paid-up additions) to avoid material charge treatment when they occur
 - Others have applied to NPT to defer material change recognition for all types of benefit increases (e.g., underwritten face amount increases), not just those resulting from the normal operation of the contract
- If so deferred, a material change must be recognized at the time an unnecessary premium is paid into the contract
- The necessary premium limitation will vary based on whether the contract is designed to comply with the CVAT or the GPT

Grandfather – IRC Section 7702

- A change after 1984 to a contract “issued” before January 1, 1985, often will cause the contract to become subject to IRC Section 7702. However, a change will not cause a contract to be treated as newly “issued” if:
 - The change does not affect the material terms or economics of the contract, i.e., the amount or pattern of death benefit, the premium pattern, the rate or rates guaranteed on issuance of the contract, or mortality and expense charges

Grandfather – Reasonable Charge Rules and Notice 2016-63

- The TAMRA effective date rule for application of reasonable mortality and expense charge rules is based on the “entered into” date of a contract
- Notice 2016-63 – What would cause an existing contract to be treated as newly issued and subject to the 2001 or 2017 CSO mortality requirements?
- Notice provides safe harbors but limits their application based on the contract’s “issue date” as determined under the Notice

Grandfather – Notice 2016-63

- § 5.01 of the Notice – IRC Section 7702 grandfather standard
- § 5.02 of the Notice – A change will not result in new “issue” treatment (losing ability to use 1980 CSO mortality for pre-2009 contracts) in the case of:
 - A change, modification or exercise of a right to modify, add or delete benefits pursuant to the terms of the contract
 - The state of issuance does not require use of 2001 or 2017 CSO
 - The contract continues on the same policy form or blank
- § 5.02 of the Notice also provides that if the only change to an existing contract is a reduction or deletion of benefits, a change from a previous table to the 2001 or 2017 CSO table is not required
- Examples provided in § 5.03:
 - Add or remove rider or QAB
 - Increase or decrease death benefit (DB) (or change in DB option)
 - Reinstate within 90 days of lapse
 - Change a rating on a policy
- Examples must be read together with the § 5.02 rule

Effective Date – IRC Section 7702A

- Generally applies to contracts “entered into” on or after June 21, 1988
- Contracts issued prior to June 21, 1988, can become subject to the IRC Section 7702A requirements under certain circumstances:
 - If the death benefit increases by more than \$150,000 over its October 20, 1988 level and there is then an IRC Section 7702A(c)(3) material change, even if a policyholder had a unilateral right to the increase
 - Any death benefit increase or QAB increase to which the policyholder did not have a unilateral right (without underwriting) prior to June 21, 1988
 - A term conversion

Administering Policy Changes

- Contract changes commonly give rise to compliance issues
- Ongoing compliance with IRC Section 7702 and 7702A is a dynamic process
 - Automated procedures are a necessity, but human oversight is critical

Types of Policy Changes

- Company-initiated changes
 - Challenging as “transactions” may not be created within the administration system to trigger processing
- Policyholder-initiated changes
 - Typically requires additional “controls”
 - New products/plan codes typically created to deal with changes in rules or assumption eras (more on this later)
- Changes occurring under the normal operation of the contract

IRC Qualification Requirements

- Policyholder administration systems determine the actuarial limitations used to measure compliance
 - Actuarial limitations are based on:
 - Rules: A particular set of tax rules (or tests) that restrict the investment orientation of the contract
 - Assumptions: A particular set of actuarial assumptions (e.g., interest, mortality and expenses) used in determining the actuarial limits
 - Tax rules and requirements around actuarial assumptions used to calculate the actuarial limitations have changed over time

Rule and Assumption Era Timeline

	1983 and earlier	1984	1985-87	1988	1989-2003	2004-08	2009-17	2017-19	2020+
RULE ERAS									
Section 101(f) - Flex. Prem. Life Ins.	Yellow								
Section 7702 - All Life Insurance		Green							
Section 7702A - All Life Insurance					Blue				
ASSUMPTIONS ERAS - EXPENSES									
Expenses Specified in the Contract	Yellow								
Reasonable Expenses					Orange				
ASSUMPTION ERAS - MORTALITY									
Mortality Rates Specified in the Contract	Purple								
Reasonable Mortality - 1958 CSO									
Reasonable Mortality - 1980 CSO					Pink				
Reasonable Mortality - 2001 CSO						Red			
Reasonable Mortality - 2017 CSO								Brown	

Material Changes, Effective Date Rules and Policy Adjustments

- What effect do policy changes have on the rule era and assumption era applicable to a contract?
 - What changes can cause a pre-DEFRA contract to be treated as newly “issued,” causing IRC Section 7702 to apply in the first instance?
 - Treatment of changes to contracts already subject to IRC Section 7702
 - Should the adjustment rule of IRC Section 7702(f)(7)(A) govern the treatment of changes “in the benefits under (or in other terms of) the contract”?
 - Are there circumstances where changes should cause a contract to be newly “issued” so that IRC Section 7702 is applied wholly anew?
 - When should changes to a pre-TAMRA contract cause it to be newly “entered into”?
- Will depend in part on:
 - The existing rule and assumption era
 - The type of policy change
 - Contract terms and guarantees
 - The business rules adopted
- A lack of authoritative guidance creates challenges
- Policyholder administrative systems necessarily adopt positions on each legal question with regard to all policy changes

Administration of Policy Changes

- Two critical elements for compliance with the material/policy change rules:
 - Understanding what changes can be made under particular contracts and the company's position on how changes should be treated for tax purposes ("business rules")
 - Understanding how the administration system is handling material changes ("administrative rules")
- Is there consistency between the business rules and the administrative rules?
 - Inconsistency can result in errors in the calculation of the actuarial limitations and administration of the actuarial tests
- Is the appropriate administrative data available for the calculation?

Concluding Thoughts

- The tax law regarding material changes may be colored in differing shades of gray, but policyholder administration systems necessarily are colored in black and white (i.e., they are rule-based)
- Keys to successfully administering material changes:
 - Understand your products
 - Understand the differing rule and assumption eras
 - Stay current on emerging guidance (e.g., Notice 2016-63)
 - Document your “business rules”
 - Verify consistency between business rules and administrative practice
 - Ongoing assessment of business rules and administrative practice is essential

QUESTIONS?

The Taxation Section Presents

Product Tax Seminar Boot Camp

September 12, 2018 | The Madison hotel | Washington, D.C.

Annuity Boot Camp

Presenters:

Mark E. Griffin, J.D.

Bryan W. Keene, J.D.

Alison R. Peak, J.D.

2018 Product Tax Seminar

Annuity Boot Camp

Mark E. Griffin

Bryan W. Keene

Alison R. Peak

The Basics of Annuity Taxation

September 12, 2018



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Overview

- Scope
 - Focuses on the federal income taxation of annuities
 - Does not address:
 - Federal estate and gift taxation
 - State taxation

Overview (cont.)

- Sessions
 - Federal Tax Definition of an “Annuity”
 - Distributions from Non-Qualified Annuity Contracts
 - Tax-Free Exchanges of Annuity Contracts
 - “Qualified” Annuity Contracts
 - Long Term Care and Combination Products

Overview (cont.)

- Sources of Law
 - Internal Revenue Code
 - Case law
 - Treasury regulations
 - Revenue Rulings and Procedures
 - Notices, Announcements etc.
 - Private Letter Rulings

Session 1: Federal Tax Definition of “Annuity”



In General

- No comprehensive statutory definition
- Defining characteristics may be discerned from:
 - Treasury regulations
 - Case law
 - Certain statutory provisions

In General (cont.)

- Treasury regulations under Code Section 72
 - “Customary” practice of life insurance companies
- Variable Contracts
 - Code Section 817(h) diversification
 - “Investor control” doctrine

Case Law and IRS Rulings

- Amortization of principal and earnings
 - Periodic payments made at least annually
 - Regulations and case law
 - Liquidation of principal and earnings
 - *Igleheart v. Commissioner*
 - Maximum annuity start date
 - Qualified v. non-qualified contracts

Case Law and IRS Rulings (cont.)

- Amortization of principal & earnings (cont.)
 - Immediate annuities with surrender values
 - IRS private letter rulings
 - Treas. Reg. sec. 1.72-11(f)
- Agreements to pay interest
 - Distinguished from annuities
 - Principal left substantially intact
 - Interest payments includible in income
 - Code Section 72(j); Treas. Reg. sec. 1.72-14

Code Section 72(s)

- Requires certain distributions after death
 - A contract issued after 1/18/85 must satisfy Code Section 72(s) *by its terms*
- Death *before* annuity starting date:
 - Entire value must be distributed within 5 years of death
 - Or over life of designated beneficiary beginning within 1 year of holder's death
 - Special rule for spousal designated beneficiary

Code Section 72(s) (cont.)

- Death *on or after* annuity starting date:
 - “At least as rapidly” rule
 - Rule permitting distributions over designated beneficiary’s life or life expectancy technically applies but generally is not employed
- Non-natural owners:
 - “Primary annuitant” treated as holder
 - Application to grantor trusts?
 - Additional special rules

Code Section 72(s) (cont.)

- Multiple holders:
 - Death of *any* holder triggers distribution rules
- Code Section 72(s) does not apply to:
 - Structured settlement annuities
 - Qualified annuities

Non-Natural Owners

- Code Section 72(u): General Rule
 - A contract owned by a non-natural person is not an annuity for federal tax purposes
 - Earnings currently taxable
 - Only for contributions to contracts after 2/28/86
 - Income on the contract for the year:
 - net surrender value at year-end plus all distributions to date, over
 - premiums paid (net of dividends) plus all taxable distributions to date
 - Insurance company taxation not affected

Non-Natural Owners (cont.)

- Exceptions
 - Contract held by a trust or other entity as an agent for a natural person or persons
 - IRS private letter rulings clarify that exception applies only if beneficial ownership of trust resides in a natural person or persons
 - Treatment of grantor trust owners?
 - Immediate annuity
 - An annuity purchased with a single premium providing payout of substantially equal periodic payments beginning within one year of purchase

Non-Natural Owners (cont.)

- Exceptions (cont.)
 - Contract acquired by decedent's estate by reason of decedent's death
 - Structured settlement annuity
 - Contract held in one of certain enumerated qualified arrangements

Variable Contracts

- In general:
 - Amounts under the contract are allocated to a state law segregated asset account (“SAA”)
- Annuity:
 - Provides for “payment of annuities”
 - Amounts paid in or out reflect investment return & market value of SAA

Variable Contracts (cont.)

- Diversification rules (Code Section 817(h)):
 - Apply to non-qualified variable contracts
 - Do not apply to pension plan contracts (IRAs, etc.)
 - Each “segregated asset account” must be “adequately diversified” according to specific rules
 - Generally means each sub-account or investment option
 - Test at end of each quarter w/ 30-day cure window

Variable Contracts (cont.)

- Investor Control Doctrine
 - Policyholder deemed to own the separate account assets for tax purposes if policyholder exercises control over them
 - *Webber v. Commissioner*
 - Three related indicators of control:
 - Actual control over asset acquisition, disposition, management
 - Use of publicly available pools of assets
 - Use of *de facto* publicly available pools of assets

Consequences of Non-Compliance

- Failure to liquidate principal and earnings
 - Fixed contracts: considered an “agreement to pay interest,” with owner currently taxable on earnings
 - Variable contracts: most likely considered a mutual fund, taxed accordingly
- Failure to satisfy Code Section 72(s)
 - Earnings currently taxable, although no published guidance regarding calculation of income
 - No published guidance for issuers to correct
 - Possible reporting and other penalties

Consequences of Non-Compliance (cont.)

- Failure to satisfy Code Section 817(h)
 - Owner currently taxable on earnings under entire contract (not just non-diversified account)
 - Ordinary income tax rates
 - Withholding and reporting requirements for issuer
 - Regaining status as an annuity
 - Not automatic; Rev. Proc. 2008-41 available to correct:
 - failure inadvertent
 - failure corrected within reasonable time
 - issuer pays toll charge

Consequences of Non-Compliance (cont.)

- Failure under investor control doctrine
 - Owner currently taxable as if owner held underlying assets directly

Questions?

Session 2: Distributions from Non- Qualified Annuity Contracts



Key Concepts

- Investment in the contract
 - Amounts paid less non-taxable amounts received
- When are amounts taxable?
 - Actual receipt
 - Deemed receipt
 - Constructive receipt
 - Lump sum payments under Code Section 72(h)

Key Concepts (cont.)

- Who is taxed?
 - Generally the person entitled to payments
 - Gratuitous transfers
 - Death benefits
- How much is taxable?
- Annuity starting date
 - The later of:
 - Date upon which obligations became fixed
 - First day of period which ends on date of first payment

Non-Annuity Payments

- “Amounts *not* received as an annuity”
 - Surrenders, partial withdrawals, dividends under a participating contract, etc.
- Received *on or after* the annuity starting date:
 - Generally, includible in gross income
 - Special rule for a full surrender – investment first treatment
- Received *before* the annuity starting date:
 - Generally, income first rule - included in gross income to the extent of income on the contract
 - Special rule for a full surrender – investment first treatment

Non-Annuity Payments (cont.)

- Additional 10% tax for early distributions
 - Exceptions to additional tax:
 - Age 59¹/₂
 - Death
 - Disability
 - Substantially equal periodic payments
 - Qualified plans (subject to separate, similar rules)
 - Pre-August 14, 1982 amounts
 - Qualified funding assets
 - Immediate annuities

Non-Annuity Payments (cont.)

- Aggregation rules
- Death benefits
 - Includible in income
 - No basis “step-up”
 - Enhanced death benefits
 - Constitute life insurance?

Non-Annuity Payments (cont.)

- Deemed distributions
 - Loans and assignments
 - Gifts and other gratuitous transfers
 - Charges to pay for certain non-annuity benefits

Annuity Payments

- Fixed annuities - exclusion ratio
 - Investment in the contract divided by expected return
 - Treasury regulation tables
 - Adjustment for refund feature
- Variable annuities - exclusion amount
 - Investment in the contract divided by expected number of payments
 - Treasury regulation tables
 - Adjustment for refund feature

Annuity Payments (cont.)

- Recovery of investment
- Commutation features
- Guaranteed periods and amounts
- Partial annuitization
 - Treated as separate contract with separate exclusion ratio
 - Annuity payments must be for life or lives, or a period of at least 10 years
 - Otherwise, treated as amounts not received as an annuity subject to the income first rule

Questions?

Session 3: Tax-Free Exchanges of Annuity Contracts



Code Section 1035 - In General

- An exchange of property is taxable under Code Section 1001, unless an exception applies
- Code Section 1035 provides an exception to this rule
- But Code Section 1035 only applies to certain types of exchanges

Types of Permitted 1035 Exchanges

	Life Insurance for ...	Annuity for ...	Endowment for ...	QLTCI for ...
Life Insurance	Yes	No	No	No
Annuity	Yes	Yes	Yes	No
Endowment	Yes	No	Generally Yes	No
QLTCI*	Yes	Yes	Yes	Yes

* A QLTCI rider on an annuity or life insurance contract will not cause the contract to fail to be treated as an annuity or life insurance contract for purposes of the tax-free exchange rules.

Same “Obligee” & “Insured”

- Same insured requirement:
 - Regs describe exchanges involving life, annuity, endowments
 - Then say Code Section 1035 n/a to “such exchanges if the policies exchanged do not relate to the same insured”
- Same obligee requirement:
 - Regs also say Code Section 1035 applies to annuity-for-annuity exchanges only “where the same person or persons are the obligee or obligees under the contract” before & after the exchange

Issues: “Same Insured”

- Application to exchanges involving annuities
 - Annuity for annuity? Life for annuity? Annuity for QLTCI?
 - Who is the insured under an annuity?
 - Annuitant? Owner? Grantor of trust? Beneficiary? Payee?
 - Before / after annuity starting date?
 - Before / after death?
 - Irrevocable designations?
 - Can you add, change, remove the annuitant without tax?

Issues: “Same Insured” (cont.)

- Single life / joint lives?
- Applicable to QLTCI?
- Applicable to combination products?

Issues: “Same Obligee”

- Who is the obligee?
- Can the obligee change during the life of a contract?
 - Owner / annuitant / payee / beneficiary?
 - On / after the annuity starting date?
 - Irrevocable designations & contingent interest holders?
 - Before / after death?

Issues: “Same Obligee” (cont.)

- Exchanges with ownership changes
 - Single owner to joint owners & *vice versa*
 - Trusts: grantor & non-grantor
- Exchanges involving annuities and other products?

Carryover Attributes

- Basis generally carries over in a 1035 exchange
 - “External” – get / give basis from / to the other carrier?
 - “Internal” – ongoing reporting obligations affected
- Any “grandfathered” treatment generally lost
 - Because contract received is “issued” on date of the exchange
 - Few exceptions

Carryover Attributes (cont.)

- Purchase date
 - Code Section 72(u)(4) “immediate annuity” definition
 - Annuity starting date must be within a year of “purchase” date
 - For this purpose, the original purchase date carries over in an exchange
 - Rev. Rul. 92-95
- Code Section 72(s)

Combining / Dividing Contracts

- Early IRS view: one-for-one exchanges only
 - *See* PLR 8741052
- Subsequent rulings: can divide / combine contracts
 - Exchange multiple contracts for a single contract
 - *See* PLR 200323012 and PLR 9708016
 - Exchange one contract for two
 - *See* PLR 200243047 and PLR 96440161

Partial Exchanges

- Partial exchanges permitted
 - *Conway v. Commissioner*
 - IRS acquiescence
 - Notice 2003-51
 - Rev. Proc. 2008-24

Partial Exchanges (cont.)

- Deferred annuities (Rev. Proc. 2011-38)
 - IRS won't challenge if no withdrawal / surrender w/in 6 mos.
 - Annuitization for life or at least 10 years is OK, too
 - Otherwise, may recharacterize using general tax principles
 - For example, as taxable boot or as taxable distribution
 - But not automatic; case-by-case IRS may raise or may not
 - Point = preclude avoidance of Code Section 72(e)
- Other product types?

Exchanges Involving:

- Existing Contracts
- Foreign Insurers
- Issuer in Rehabilitation
- Life Insurance Contracts

Treatment of “Boot”

- “Boot” = other property / money received in the exchange
 - Gain (but not loss) recognized to extent of boot
 - New basis = carryover - \$\$ received + gain recognized
- Where boot may arise:
 - Cancellation of a policy loan
 - Withdrawal in conjunction with (or just before?) exchange
 - Premium bonus credited to contract received in exchange
- Internal vs. external exchanges
 - Reporting and basis tracking

Treatment of Failed Exchanges

- In general
 - “Gain” includible in gross income
 - 10% additional tax could apply
- Loss deduction possibly available
- Other tax-free rules (*e.g.*, Code Section 1041)

Other Issues with Exchanges

- Exchange of payout annuity
- Post-death annuity exchanges & Code Section 72(s)
- Aggregation rule

Questions?

Session 4: “Qualified” Annuity Contracts



Overview

- Annuities may be used to fund:
 - Qualified plans under Code Section 401(a)
 - Qualified annuities under Code Section 403(a)
 - Code Section 403(b) annuities
 - IRAs under Code Sections 408 & 408A
 - Deferred compensation plans under Code Section 457

Overview (cont.)

- Contributions
 - May or may not be deductible or excludible
 - Saver's Tax Credit may be available
- Earnings not currently taxed
- Distributions may be excludible
- May be issued to individual or plan

IRAs - In General

- Types of IRAs
 - Traditional IRA
 - SEP IRA
 - SIMPLE IRA
 - Roth IRA
- Form and operational requirements

Traditional IRAs

- Maximum annual contributions
 - \$5,000, indexed for inflation
 - “Catch-up” contributions for individuals age 50+
 - Special rules for spouses
- Deductible & non-deductible contributions
- No contributions after age $70\frac{1}{2}$
- Minimum distribution & incidental death benefit requirements

SEP IRAs

- “Simplified Employee Pension”
- Contributions
 - Employer contributions:
 - Limited to the lesser of:
 - 25% of employee’s compensation or
 - \$55,000 for 2018
 - Excludible from gross income
 - Nondiscrimination requirements apply
 - Employee contributions

SIMPLE IRAs

- “Savings Incentive Match Plan for Employees of Small Employers”
- “Eligible employee”
- Salary reduction
- Employer contributions

Roth IRAs

- Contributions
 - Permitted after age 70¹/₂
 - Not deductible
 - Taxable if “converted” from a non-Roth IRA
 - Income limits (or not?)
- “Qualified” distributions excluded from gross income
- Incidental death benefit and lifetime RMD rules do not apply
- No recharacterizations of conversions

403(b) Annuities

- Annuity contract purchased for:
 - An employee of a tax-exempt organization;
 - An employee of a public school or university; or
 - A minister
- Contributions
 - Types
 - Limitations
- Withdrawal restrictions apply

403(b) Annuities (cont.)

- Designated Roth accounts permitted
 - Similar to Roth IRAs
 - Contributions
 - Distributions
 - Regulations
 - Separate accounting requirement and issues involving Roth and non-Roth monies in same contract
 - Aggregation and reporting issues
 - Effective date
 - Other issues

403(b) Annuities (cont.)

- Regulations
 - Reflects general desire to conform Code Section 403(b) rules to rules applicable to qualified plans
 - Requirements include:
 - Written plan requirement
 - No more “Rev. Rul. 90-24” transfers
 - No more incidental life insurance
 - New withdrawal restrictions
 - New nondiscrimination testing
 - Effective generally beginning 2009
 - Special grandfather rules
 - Special delayed effective date rules
 - Special transitional rules (Rev. Proc. 2007-71)

401(a) Qualified Plans

- An annuity contract may be:
 - Held by a trust for a qualified plan
 - Used to establish and fund a “non-trusteed” plan
- Annuity generally must:
 - Comply with tax requirements applicable to plan
 - Comply with terms of plan
- Contributions - limits depend on type of plan
 - Defined contribution plans (Roth & non-Roth)
 - Defined benefit plans
 - Designated Roth accounts permitted

403(a) Qualified Annuities

- Like a qualified plan but does not involve a qualified trust
- Same requirements generally apply

Deferred Compensation Plans

- “Eligible” deferred compensation plan
 - Established & maintained by
 - A state or local government
 - Any other tax-exempt organization
 - Trusteed requirements for governmental plans
- Contributions - elective deferral limits apply
- Distributions
- Special rules if fail to qualify as an “eligible” deferred compensation plan

Incidental Death Benefits

- Pre-retirement incidental benefit requirements
- Minimum distribution incidental benefit (or “MDIB”) rule

RMDs - In General

- “Required Minimum Distributions”
- Rules generally apply to all types of qualified plans
- Consequences of failure to satisfy:
 - 50% excise tax applies
 - Possible plan disqualification
- Special rules for:
 - IRAs and 403(b)s
 - QLACs

RMDs - In General (cont.)

- General rules:
 - “Individual account” rules: divide account balance by life expectancy factor each year
 - “Annuity” rules: payment stream must comply

RMDs - In General (cont.)

- Deferred annuities:
 - Subject to individual account rules
 - “Account balance” is the sum of:
 1. The “*amount credited*” under the contract, plus
 2. The “*actuarial present value*” of “*additional benefits*” is treated as part of account value
 - Subject to special rule excluding QLACs

RMDs - Lifetime Requirements

- Distributions must commence:
 - By the “required beginning date” and
 - Over life/life expectancy of owner, or
 - Over joint lives/life expectancies of owner and “designated beneficiary”
- Required beginning date
 - April 1 of calendar year following later of year in which owner attains age $70\frac{1}{2}$ or retires
 - Special rule for IRAs and 5% owners; Roth IRAs

RMDs - After Death Requirements

- Death *after* distributions have begun - “at least as rapidly” rule
- Death *before* distributions have begun
 - 5-year rule
 - Life/life expectancy rule
- Special IRA rules for spouses

RMDs - QLACs

- Longevity risk
- Response: Deferred income annuity (DIA) with no cash value that provides annuity payments commencing at a specified age, *e.g.*, 85
- RMD problems
 - Payments commence after required beginning date
 - RMDs are determined taking into account the “actuarial present value” of a DIA
 - DIA lacks accessible value with which to satisfy RMDs

RMDs – QLACs (cont.)

- Final regulations
 - Ignores a “qualifying longevity annuity contract” (“QLAC”) for determining RMDs
 - Effective for contracts purchased on or after July 2, 2014

RMDs – QLACs (cont.)

- QLAC defined:
 - A commercial, fixed annuity stating it is intended to be a QLAC
 - Premiums limited to lesser of 25% of account balance & \$125,000 (adjusted for inflation)
 - Annuity starting date must occur no later than age 85
 - No cash value, commutation benefit, or similar feature
 - Annuity payments must satisfy the RMD rules
 - Death benefits limited to return of premium & certain life-contingent survivor annuities

Taxation of Distributions

- Pre-tax amounts vs. after-tax amounts
- “Qualified distributions” from Roth IRAs and designated Roth accounts
- Distribution of annuity contract from qualified plan
- 10% additional tax on premature distributions

Loans

- Loans generally allowed (except IRAs)
- Loans subject to Code Section 72(p) limits
 - Amount of the loan
 - Time and manner of repayment
 - Failure could result in
 - Taxation of remaining loan balance
 - Disqualification

Rollovers and Transfers

- Trustee-to-trustee transfers
 - Not treated as distributions
 - Allowed between arrangements of same type
- Rollovers from IRAs
 - Tax-free if rolled over within 60 days
 - Pre-tax amounts can be rolled over to traditional IRA, qualified plan, qualified annuity, Code Section 403(b) arrangement, or governmental 457(b) plan

Rollovers and Transfers (cont.)

- Rollovers from IRAs (cont.)
 - After-tax amounts can be rolled over to another IRA
 - Once-a-year rollover limit
 - Originally interpreted by IRS as applying separately to each IRA
 - Tax Court in *Bobrow v. Commissioner* concluded that the limit applies across all IRAs
 - IRS adopted Tax Court view
 - Special rules for SIMPLE IRAs and Roth IRAs

Rollovers and Transfers (cont.)

- Rollovers from other retirement plans
 - An “eligible rollover distribution” can be rolled over tax-free within 60 days to an “eligible retirement plan”
 - Rollovers of after-tax amounts; ordering rules apply
 - Direct rollover
 - Indirect rollover (20% mandatory withholding applies)
 - Rollover from designated Roth account to Roth IRA
 - Rollover by non-spouse beneficiary into an “inherited” IRA

Failure to Qualify as a Tax-Favored Retirement Plan

- EPCRS available to correct plan failures
- EPCRS not available for IRAs

ERISA

- Employee Retirement Income Security Act of 1974
- Employer plans subject to ERISA
- Additional rules apply to ERISA plans:
 - Documentation, reporting, and disclosure
 - Substantive requirements
 - Fiduciary rules

Questions?



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Overview

- HIPAA's Tax Clarifications for LTC Insurance
- Types of Combination Products
- Favorable Tax Treatment of Combination Products
- 7702B Requirements
- 7702B Requirements as Applied to Combination Products
- 101(g) Requirements (Chronic Illness)
- 101(g) Requirements (Terminal Illness)
- ADB Tax Implications under Sections 72, 7702 and 7702A
- 1035 Exchanges of Combination Products

HIPAA's Tax Clarifications for Long-Term Care Insurance

- Uncertain tax treatment of long-term care (LTC) insurance prior to enactment of the Health Insurance Portability and Accountability Act of 1996 (HIPAA)
- LTC involves both medical care and personal elements
- Section 7702B – Defines a qualified long-term care insurance (QLTCI) contract
 - Accident and health (A&H) insurance tax treatment of benefits
 - Premiums deductible as costs for medical care
 - Rules imposed to preclude excessive investment orientation, e.g., benefit triggers and cash value limits
 - Consumer protection requirements
 - Operates as a safe harbor

Types of Combination Products

- Life Insurance-QLTCL Products
 - Authorized by HIPAA in 1996
 - LTC portion of contract can provide LTC accelerated death benefits (ADB) and / or non-acceleration LTC benefits
- Section 101(g) Chronic Illness ADBs
 - Enacted by HIPAA in 1996
 - State regulation generally either as LTC insurance or under state laws based on the NAIC's Accelerated Benefits Model Regulation
 - Requirements are similar to (but not the same as) those applicable to life insurance-QLTCL ADBs
- Section 101(g) Terminal Illness ADBs
- Annuity-QLTCL Products
- Other, such as life insurance – critical illness ADBs

Types of Combination Products (cont.)

- Annuity-QLTCL Products
 - Authorized by Pension Protection Act of 2006 generally for years after 2009
 - PPA contemplates funding of LTC benefits from both annuity cash (or payment) values and net amount at risk
 - Possible structures – Coinsurance and tail designs for deferred annuities; bump-ups for immediate annuities and annuitizations; other variations
 - Insurance contract requirement - PLRs 200919011, 201105001 and 201213016
 - Combination annuity-LTC products not permitted in IRA and other qualified arrangements
 - Effect of LTC benefits on “investment in the contract”?

Favorable Tax Treatment of Combination Products

- QLTCI benefits received from the LTC “portion” of a contract generally are treated as excludable A&H benefits under section 104(a)(3)
 - “... if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the life insurance contract’s death benefit or cash surrender value or in the annuity contract’s cash value.” Joint Committee on Taxation’s explanation of H.R. 4, p. 195 (JCX-38-06).
- Section 101(g) chronic illness and terminal illness ADBs are generally excludable from income as death benefits
- Per diem rule limits extent of exclusion for periodic (non-reimbursement) chronic illness benefits

Favorable Tax Treatment of Combination Products (cont.)

- Per diem rule's limits apply to both QLTCI and section 101(g) chronic illness riders – \$360/day (or \$131,400/year) in 2018, subject to adjustments
- The per diem limit is based on the period for which benefits are paid, regardless of the year during which they are actually paid
 - Form 1099-LTC, in contrast, is based on calendar year of payment
 - Benefits for a period beyond the current calendar year?
 - Overlapping and non-overlapping periods of chronic illness
- Charges to fund QLTCI riders are not income, but reduce “investment in the contract” under section 72
 - Reporting Obligation – Section 6050U

7702B Requirements for Qualified Long-Term Care Insurance

- Coverage only of qualified long-term care services
 - Services required by a chronically ill individual
 - Provided pursuant to a “plan of care” prescribed by a licensed health care practitioner
- Chronic illness requirement – A licensed health care practitioner (as defined in the tax law) must have certified within the prior 12 months that the insured either:
 - needs substantial assistance with at least 2 of 6 activities of daily living, or
 - requires substantial supervision to protect the insured from threats to health and safety due to severe cognitive impairment
- Limits on cash values (certain return of premium benefits permitted on the insured’s death or contract surrender)
- Other requirements – Guaranteed renewable, Medicare coordination, and consumer protections

Section 7702B Requirements as Applied to Combination Products

- Section 7702B(e) treats the LTC “portion” of the contract as a separate contract for purposes of the entire Code
 - This allows section 7702B qualification rules to apply to the LTC rider without regard to the life insurance or annuity contract
 - Thus, life coverage ignored in applying the requirement under which coverage must only be of QLTC services
 - Similarly, life contract cash values ignored in applying cash and loan value restrictions that apply to QLTCI
 - As noted, generally cannot use with employer or qualified retirement arrangements
 - Separate contract treatment extends to non-qualified LTC insurance riders
 - ROP benefits provided by a QLTCI rider in conjunction with life insurance ROP benefits
 - Other morbidity risk ADBs?

Section 101(g) Requirements (Chronic Illness)

- Chronic illness requirement
 - Same as that applicable to QLTCI
- Benefits generally must reimburse costs incurred by the payee for QLTC services and Medicare coordination requirement
 - Special rule for per diem benefits
- Consumer protection requirements -- They differ from those under section 7702B(g)
 - NAIC-based requirements
 - State law requirements
 - Choice of state regulatory regime and effect on rider design
 - There may be good reason to structure as LTC, such as greater flexibility for payment of dividends, nonforfeiture offer requirements, marketing considerations, or in view of the treatment of return of premium values
- Exception for business-related policies
- Funding – NAIC describes charges, actuarial discount, lien method

Section 101(g) Requirements (Terminal Illness)

- A physician (as defined in section 1861(r)(1) of the Social Security Act) must have certified that the insured has an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification
 - Physician requirement less broad than licensed health care practitioner
 - Generally U.S. physicians only
 - QLTC services are not geographically limited
- Exception for business related policies
- What if the insured survives?

Effect of ADB Benefit Payments under Sections 72, 7702 and 7702A

- “Investment in the contract” under section 72
- Adjustment rule under section 7702(f)(7)(A)
- “Premiums paid” under section 7702(f)(1)
- Benefit reduction rule of section 7702A(c)(2) and material change rule of section 7702A(c)(3)
- “Amount paid” under section 7702A(e)(1)

Section 1035 Exchanges of Combination Products

- Life insurance and annuity contracts can be exchanged tax-free for QLTCI
 - Partial assignments of deferred annuity value?
 - Partial assignments of immediate annuities?
- QLTCI for QLTCI
- Parties to a contract –
 - Same insured (life requirement); same obligee (annuity requirement)
 - What about for exchanges involving QLTCI?
- Special rule for exchanges involving LTC riders
 - Riders generally disregarded
 - Exchanges where QLTCI riders receive (or provide) no value

Questions?